Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:TL-N-1190-99
HBDow (312) 886-9225 x. 403 (FAX) (312) 886-9244
G:\CASES\[redacted]wpd

date: June 27, 2000

to: District Director, Illinois
Attn: Robert Maio
Case Coordinator E:1102

from: District Counsel, Illinois CC:MSR:ILD

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ject: [redacted] Conversion Costs

[redacted]
EIN: [redacted]
Years: [redacted]-[redacted]

This will confirm my telephone conversation with you today concerning your writeup of this issue on Form 886, together with the additional material submitted to you by the taxpayer.

I advised you that I did not have any changes to recommend to your writeup. (b)(7)a [redacted]

Richard A. Witkowski
District Counsel

By:
HARMON B. DOW
Special Litigation Assistant

010762

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:MSR:ILD:TL-N-1190-99
HBDow (312) 886-9225 x. 403 (FAX) (312) 886-9244
G:\CASES\[redacted].wpd

date: December 21, 1999

to: District Director, Illinois
Attn: Robert Maio
Case Coordinator E:1102

from: District Counsel, Illinois CC:MSR:ILD

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subject: [redacted] Conversion Costs

[redacted]
Attn: [redacted]
Director of Corporate Tax
EIN: [redacted]
Years: [redacted]-[redacted]
No Power of Attorney on file

I. Issues

Should costs associated with the termination of the taxpayer's [redacted] be capitalized against the basis of the [redacted] which continued to be held by the taxpayer after all the other assets of the business were disposed of?

II. Conclusion

The costs of converting the customers to a competitor's system, or paid to customers that did not want to convert, should be capitalized to the basis of the [redacted]. However, this amount should be offset by the income reported on the sale of the customer list to [redacted].

III. Facts

[redacted], through its [redacted], [redacted], was in the business of developing, manufacturing, marketing and supplying a [redacted] known as [redacted], using [redacted]

[redacted] systems. This type of service is commonly known as "[redacted]." [redacted] also had [redacted].[1]

During the late [redacted]s and early [redacted]s, there was significant consolidation in the [redacted] industry, with [redacted], [redacted], [redacted] and [redacted] emerging as the largest holders of [redacted]. In this context, [redacted] determined that it wanted to be a [redacted].

Beginning in [redacted], [redacted] began discussions with [redacted], concerning various proposals to combine their [redacted] systems. During [redacted], these discussions progressed to the point where the subject was the possible transfer of [redacted]'s [redacted] to [redacted] in exchange for an equity interest in [redacted]. Both [redacted] and [redacted] also were engaging in discussions with other companies which would impact any agreement reached by the two companies. It was [redacted]'s objective to be primarily a [redacted] supplier and equipment manufacturer rather than a [redacted].

In [redacted], [redacted] and [redacted] entered into a nonbinding agreement which provided for [redacted] to transfer to [redacted] [redacted]'s [redacted] business in certain areas, and also an interest in [redacted], in exchange for [redacted] shares of [redacted] common stock. At the same time, [redacted] entered into an agreement with an unrelated third party, [redacted] to sell [redacted] assets, under which some of [redacted]'s [redacted] customers would be converted to [redacted]s [redacted]. This would free up the [redacted] for transfer to [redacted]. [redacted] evidently intended to use the [redacted] purposes rather than [redacted].

[redacted] offered its [redacted] customers the alternative of returning their [redacted] to [redacted] in exchange for cash, or trading the [redacted] for new [redacted]. Those who traded their [redacted] in were sold, in the form of a customer list, to [redacted], for $[redacted].

Thereafter, [redacted], [redacted], [redacted], [redacted] and [redacted] discussed various ways in which their businesses would operate or be combined, and in [redacted], [redacted] and [redacted] announced a merger that superseded the [redacted] [redacted] agreement.[2]

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[1] [redacted].

[2] Nevertheless, it is evident that the taxpayer and [redacted] had a continuing understanding about the ultimate goal of merging, in some fashion, their operations. [redacted]

In [redacted], the taxpayer and [redacted] entered into a merger agreement providing for the taxpayer contribute its [redacted] to [redacted],[3] a wholly owned subsidiary of [redacted], and under which [redacted] would be merged into [redacted]. The taxpayer acquired [redacted] shares of "new" [redacted], representing [redacted]% of [redacted]'s voting securities.

In order to handle the trade-ins under the [redacted] agreement with [redacted], [redacted] acquired [redacted] at what seems to have been a substantial discount from [redacted]. This [redacted] was then exchanged for the old [redacted], and for purposes of this opinion you have advised us that we can assume that the value of the old [redacted] and the new [redacted] was roughly equivalent.[4]

The total cost to convert the [redacted] customers was $[redacted]. For book purposes, these costs were initially recorded to an asset account for deferred costs. In [redacted], those costs were transferred into the [redacted] account. For tax purposes, [redacted] took a [redacted] schedule M-1 tax deduction of $[redacted], with the balance of $[redacted] being deducted in [redacted].

In addition to the conversion costs, for [redacted] wrote off the remaining tax basis in its [redacted] infrastructure ($[redacted]), wrote off accounts receivable due from [redacted] customers ($[redacted]), and bought out certain customers who did not elect to convert to [redacted] ($[redacted]), all of which were deducted on the [redacted] return.

V. Discussion

During the years immediately prior to [redacted], the taxpayer was operating a business [redacted]. Economic conditions in the [redacted] industry fostered consolidation of existing businesses, and the [redacted] were the critical assets in the consolidations, there being a limited number of them available in any particular location. The taxpayer decided that the best position for it to occupy in the emerging industry was as a supplier of [redacted]. Accordingly, the taxpayer determined use the [redacted] to acquire an equity stake in another corporation in the industry. This was ultimately accomplished by the taxpayer acquiring an interest in [redacted].

If the [redacted] were to be available for the [redacted] transaction, the [redacted] business would no longer be able to operate. Evidently, the taxpayer was unable to shift its customers to its other [redacted], and yet needed to get them off of the [redacted] transfer to [redacted]. Therefore, beginning in [redacted], the taxpayer undertook to shut down its [redacted] business and transfer its customers to [redacted] so that it could have the [redacted] available to transfer to [redacted] as part of a § 351 transaction which was carried out in [redacted].

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[3] [redacted] also assumed management of the taxpayer's [redacted].

[4] You have advised us that this is not necessarily true, but that you do not perceive that investigating the details will lead to any material tax adjustments.

The question presented is whether the costs associated with the shutdown of the [redacted] business and transfer of the customers can be written off or otherwise deducted immediately, or should be capitalized against the basis of the [redacted] that were freed up for transfer, ultimately, [redacted] as part of a § 351 transaction, under which [redacted] acquired stock in [redacted].

There are many cases involving facts where for one reason or another, owners of real estate or a leasehold bought out leases or subleases. The taxpayers invariably argue that the amounts that it paid should be immediately deductible, or amortized over the life of the acquired lease or sublease. The courts, however, hold that the costs are capital expenditures, then ascertain from the facts what asset the costs should attach to. When a lease and sublease are involved, the government's position has been that the costs attach to the lease, and should be amortized over the remaining term of the lease rather than the remaining term of the sublease. *See* Third National Bank in Nashville v. U.S., 454 F.2d 689 (6th Cir 1972). *See also* Houston Chronicle Publishing Company v. U.S., 481 F.2d 1240 (5th Cir. 1973).

We regard the present case as analogous to the lease cases. The taxpayer, via the [redacted], owns the equivalent of leases entitling it to [redacted]. By contracting with third parties to provide [redacted] service, it encumbers the [redacted] in a manner similar to the encumbrance created by a sublease. The cost of freeing the [redacted] from that use are not ordinary business expenses, but rather, costs which pertain to the [redacted] themselves, and thus are capital in nature. *See* GCM 39606, 1-101-86 (Feb 27, 1987)

Since the [redacted] have a useful life beyond one year the costs, normally could be amortizable over the term of the [redacted], which we understand to extend into the future. There being no ascertainable useful life[5] for the [redacted], and inasmuch as they were acquired prior to the enactment of I.R.C. § 197, it would appear that the costs would not be subject to amortization, unless they are franchises under § 1253. *See* Jefferson-Pilot Corporation v. Commissioner, 995 F.2d 530 (4th Cir. 1993).

However, even if an amortization period could be determined, the taxpayer decided that the [redacted] would no longer be used for [redacted], nor, indeed, for any other business purpose. Rather, it held the [redacted] for purposes of investment; i.e, in anticipation of exchanging them for capital stakes in another corporation. Accordingly, the costs are not amortizable, being held neither for use in a trade or business nor for the production of income as required by I.R.C. § 167(a).

It is our view that (b)(7)a [redacted]:

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[5] It is our understanding that for all intents and purposes, the taxpayer possesses these [redacted] forever, subject only to renewal fees. (b)(7)a [redacted].

(1) (b)(7)a [redacted] - $, (b)(7)a [redacted]
(2) (b)(7)a [redacted] - $ (b)(7)a [redacted]
(3) , (b)(7)a [redacted] - $, (b)(7)a [redacted]

These amounts are clearly associated with freeing up the [redacted] so that they could be transferred to [redacted].[6]

We do not believe, however, (b)(7)a [redacted]

Furthermore, we recommend that (b)(7)a [redacted].

Ultimately, of course, the amounts capitalized to the bases of the [redacted] winds up as part of the basis of the taxpayer's stock in New [redacted], acquired in the § 351 transaction in which the taxpayer acquired stock in New [redacted].

This opinion was reviewed in our national office by Russ Pirfo and Beverly Katz , and incorporates recommendations which were made by them.

Richard A. Witkowski
District Counsel

By: ______________________
HARMON B. DOW
Special Litigation Assistant

cc: Assistant Chief Counsel (Field Service) CC:DOM:FS
Attn: Russ Pirfo CC:DOM:FS:IT&A
Assistant Regional Counsel (Tax Litigation) CC:MSR:TL
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[6] In this regard, (b)(7)a [redacted]